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U.S. BUSINESS OUTLOOK, SHORT-TERM

The economy unquestionably slumped into recession in 1980's second quarter. But, notwithstanding the third-quarter uptick in gross national product (GNP), is the economy now in a recovery?

Technically speaking, the answer seems to be "yes." After all, the economy did grow in the July-September period. Yet growth was just 0.9% at an annual rate. Moreover, much of the good news in the third quarter was due to a sharp improvement in net exports, which in turn resulted from the basic weakness of the economy: Oil imports plunged because demand was low and petroleum inventories were high.

In addition, two other points may overshadow the fact that the economy blipped up last quarter: One, real third-quarter GNP--GNP adjusted for inflation--was still 2.3% below first-quarter GNP. Thus, even though headlines announced that the economy had perked up, the level of activity doesn't look so good compared to pre-recession levels. Secondly, besides net exports, consumer spending also boosted real GNP in the third quarter; but the spending spurt arose in part from a big increase in Social Security payments effective last July--an increase that will not be repeated for another year. Moreover, even though consumer spending jumped up in the third quarter as a whole inflation-adjusted spending declined in September and may also have fallen in October. The implication is that the July-August rise may have been merely a temporary reaction to the Social Security increase as well as to the government's removal of credit controls imposed last March.

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Housing, too, showed strength in the third quarter. Starts surged to 1.4 million (annual rate), up 33% from the second quarter. But again there were some catches--mortgage rates began to rise swiftly, new house prices took a jump, and the flow of deposits to thrift institutions slowed considerably. One result: Sales of new homes in September nosedived to 554,000--nearly 100,000 below the August sales figure.

Thus, even though growth got back into the plus column in 1980's third quarter, the nation's economic health hardly became robust. In fact, though the third quarter may be labeled the start of economic recovery, it was a recovery in name alone, providing little foundation for future vigorous growth.

The Carter Bequeathal

The near-term future, then, promises to be marked by low rates of growth, and high rates of inflation and unemployment--the same bugaboos that have haunted the economy for the past several quarters. But even worse, the economy that Ronald Reagan inherits from Jimmy Carter could actually be deteriorating.

Chief among the recovery-restraining culprits is the rise in interest rates. Typically, interest rates come down during the latter parts of recessions as loan demand weakens and as inflation abates. And, true to form, both loan demand and the inflation rate did subside during the second quarter; consequently, interest rates fell.

It's also typical for interest rates to stay relatively low in the aftermath of recession: Business takes some time to get back into a borrowing mood, and lenders reduce the inflation premium they build into

the rates they charge. In 1980, however, the economy threw away this part of the script. And instead of getting a financial breather, businessmen and consumers and house seekers had to think again about taking on new debt. The rates they faced in 1980, through October, are shown below. Rates, of course, continued to rise uncomfortably in November.

1980 Interest Rates

	Prime Rate	Corporate Bond Yield	Mortgage Rate	Auto Loan Rate
January	15.3%	11.7%	13.1%	
February	15.6	13.2	13.1	14.2
March	18.3	14.1	14.7	
April	19.8	13.4	16.6	
May	16.6	11.6	15.7	15.4
June	12.6	11.1	13.4	
July	11.5	11.5	12.6	
August	11.1	12.3	12.5	14.8
September	12.2	12.7	13.2	
October	13.7	13.0	13.8	15.6[a]

[a] Estimate for fourth quarter. Auto loan rates are available on a quarterly basis only.

Probably the main reason interest rates have bounced back so quickly is that inflationary expectations were ignited by a faster-than-expected end to recession; and lenders wanted to protect themselves against the declining purchasing power of dollars they'll get paid back in. In addition, even though the Federal Reserve Board has a declared policy of restraining money supply growth, the agency has had problems meeting its targets on a weekly basis; and large week-to-week

swings in the money supply have rattled the money markets, putting upward pressure on interest rates as lenders sought security.

The upturn in interest rates is unwelcome in and of itself, although the effects of the rise probably haven't yet shown up in reported economic data. The most noticeable effect of the rate rise thus far has been in housing--viz., the slump in new home sales and the slowing of deposit inflows to thrift institutions. The thrifts, nevertheless, still have large sums committed to mortgage lending, which should help prevent the housing market from collapsing in the face of high mortgage rates. In addition, the number of housing units builders began to put up surged in the third quarter; and as work continues on these units, residential investment--the housing component of GNP--should show strength even as new starts decline.

Thus, while the mortgage rate runup should undermine the strength that was rapidly building in the housing market, the momentum already established will be giving the economy a shot in the arm. In fact, residential investment is expected to be one of the healthier sectors of the economy in the next couple of quarters.

Nonresidential fixed investment, by contrast, has no momentum and will continue to be a weak sector of the economy for a couple of quarters at least. There is no momentum because the sharp drop in demand in the second quarter left firms with plenty of spare capacity, so plans to add new capacity could be delayed. The steep recession also crunched corporate cash flow, putting business in the position of worrying more about meeting short-term obligations than about buying capital goods for future production. With industry's operating rate at about 75%--ten

points below a year ago--and with inventories still somewhat high, there is little incentive from the supply side for business to step up capital spending.

Nor is there much incentive from the demand side, despite the resumption of growth in the third quarter. Looking into next year, most businesses foresee a sluggish rise in real GNP and some expect a continued recession, according to McGraw-Hill's fall survey of business' capital spending plans. The same survey found that business intends to hike real plant and equipment spending next year buy just 1.8%. Since the survey was conducted, however, interest rates have been on the rise. And at least in the near term, capital spending plans could certainly be cut back further as companies wait for interest rates to decline.

Meanwhile, as rates fell during part of the third quarter, real consumer expenditures leaped by more than 5% (annual rate). But that rate of advance does not appear sustainable--climbing interest rates should thwart a continued consumer comeback, for two reasons.

First, in the face of increased auto installment rates, consumers will likely downshift their plans to buy new cars. And car buying to a significant degree drove the third-quarter revival of consumer spending: Real expenditures on motor vehicles and parts zoomed by nearly 50% (annual rate) in the third quarter. If auto sales stall, consumer spending will flatten out. Secondly, high interest rates could stimulate consumers to save more, thereby reducing the amount of income spent on goods and services. (Come January, consumers will also find their spendable income reduced by an increase in Social Security taxes.) The saving rate is expected to remain low, though, since incomes will be

growing only slowly in the next few months and consumers will be spending to maintain standards of living.

In sum, high and rising interest rates are putting the recovery on hold: Rates in the near term will crimp house building, further darken an already cloudy capital spending outlook, and make consumers think twice about buying on credit. Thus the recovery, which may have begun in the third quarter, is not expected to pick up steam in 1980's fourth quarter. Nor is the first quarter of next year expected to show much, if any, strength--because of interest rates and because of the Social Security tax increase in January. It would not be surprising, in fact, to see the economy actually decline in one of the next two quarters.

Looking Across the Plateau

If, as expected, economic activity in the near term is sluggish, some good should come of it--in particular, interest rates should decline, setting the stage for a solid recovery in the second half of 1981.

Thus, looking beyond the next two quarters of "waffling sideways," the economy looks pretty good. After stumbling over high interest rates in the near term, housing should get back on track as rates come back down: Lots of people delayed buying houses during the recession, and more are delaying now because of financing constraints. Very simply, there is a large pent-up demand for housing.

Consumers, for their part, are preparing to increase expenditures by continuing to ease their debt burden. True, after liquidating installment debts from April through July, consumers began to borrow

again in August and September. But since income has been rising at a faster rate than debt, the ratio of installment credit outstanding to personal income--a key measure of consumer liquidity--has continued to fall. In other words, consumer debt relative to ability to pay has been shrinking. And once consumers feel comfortably liquid, they will again begin to accummulate debt to finance purchases.

After housing and consumer buying pick up, new orders to businesses will increase, spurring firms to add to capacity, modernize plant and equipment, and build inventories. The economy should then expand further in 1982, thus completing the recession-recovery-expansion cycle that right now seems short-circuited between recession and recovery.

The Tax Cut Complication

Assuming that the economy next year will move neatly from recovery to expansion overlooks an obstacle, however, because next year is not just any year. A new President advocating tax cuts, backed up by a new Congress disposed towards tax cuts, will be taking office. The question this event raises is not so much the size of a tax cut--$30-$40 billion is likely--but the timing. For the timing will affect the federal budget deficit, which in turn affects inflation and interest rates, which in turn affect the whole economy.

The federal deficit in 1980 is about $60 billion; next year it will also be huge. A large deficit is par for the course in a recession as tax revenue drops and government transfer payments aimed at cushioning the shocks of recession rise. Moreover, since credit demands are generally low during recession, the government is able to obtain funds without putting undue pressure on financial markets--without, that is, forcing up interest rates and forcing out private sector borrowers.

Also, if inflation is abating, a widening government deficit may not much affect inflationary expectations.

The current situation, though, is somewhat different: While the economy is weak, no further steep declines in GNP are foreseen. Business loan demand has been increasing in recent months, and both inflation and interest rates are going up. Meanwhile, the Federal Reserve Board is resolved to stick to a tight-money policy, which means the pool of borrowable funds will be growing slowly. If an early tax cut balloons the federal deficit, then increased government credit demands could cause gyrations in an already jittery money market.

In addition, expectations of higher inflation would ratchet up the premium that lenders tack onto interest rates. Inflationary expectations rise along with increases in the federal deficit because it's assumed the Fed will accommodate the deficits by pumping up the money supply. The Fed has pledged not to do that, but if faced with skyrocketing interest rates ignited by an enlarged deficit, the temptation would be great to try to ease the pressure by speeding up the printing presses.

The Reagan administration could avert this tax cut/deficit dilemma by chopping the federal budget before cutting taxes. If in the flush of victory the Republicans surge into Washington in January and immediately pass a tax reduction law, unaccompanied by budget cuts, a spurt in interest rates and inflation could derail the already shaky recovery. In particular, the housing industry could get clobbered.

In the forecasts presented at the end of this report, it is assumed instead that a tax cut does not become effective until mid-1981. By that time, interest rates should be lower than they are now, the government's recession-related spending will be down, and budget cuts should have been made. In short, it is assumed that tax cuts will not destablize financial markets.

Given the stimulus of both personal and business tax cuts in mid-1981, the economy is expected to grow at a healthy 4% annual clip in the second half of next year. The pickup in activity will be spearheaded by housing--which will be enjoying the benefits of strong underlying demand, and by capital investment--which will be spurred by tax incentives and by increases in demand. As demand grows, business will also add to inventories, thereby providing further strength to the economy.

Summary

Yes, the economy managed to grow a bit in the third quarter of 1980, signaling the end of a sharp--and surprisingly short--recession. But no, the third quarter did not set the stage for takeoff into economic expansion. A key reason: High and rising interest rates.

While in previous post-recession periods interest rates typically leveled off or even declined, this time around they began to rise very early in the "recovery." Perhaps the first warning of what rising rates will do was the sharp drop in new home sales in September. For the next quarter or two, the impact of high interest rates is also expected to show up in sluggish spending by consumers and businesses.

The impact could be so great, in fact, that real GNP could take a dip in 1980's last or 1981's first quarter. The silver lining here is that due to continued slow (or even negative) growth, interest rates should decline, providing impetus to housing and business fixed investment. Consumers, meanwhile, will be thinking again about buying on credit; and if they feel liquid as interest rates fall, consumer spending would rebound. This rebound is epected to begin in next year's second quarter.

The wild card in this scenario is the incoming Administration's fiscal policy. A tax cut is a certainty. But if it comes too early in 1981 and is unaccompanied by budget cuts, inflation and interest rates could take off. In that event, economic recovery--once again--would be undermined, and the expansion pushed further into the future.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual		Forecast					Annual		
	1980		1980	1981						
tional Product Accounts	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1979	1980	1981
Gross National Product	2521.3	2586.5	2653	2716	2790	2865	2984	2368.8	2570.5	2843.9
Consumer Spending	1626.6	1683.3	1725	1763	1812	1870	1930	1509.8	1666.1	1843.8
Gross Private Domestic Investment	368.5	348.4	366	387	406	434	457	387.2	367.7	421.0
Fixed Investment	357.1	365.2	373	384	398	421	442	369.0	369.6	411.3
Nonresidential	268.2	270.9	275	280	286	297	308	254.9	271.7	292.8
Residential	88.9	94.2	98	104	112	124	134	114.1	97.9	118.5
Inventory Change	11.4	- 16.8	- 7	3	8	13	15	18.2	- 1.9	9.8
Government Purchases	528.3	533.6	552	564	576	589	608	476.4	532.8	584.3
Federal	193.3	191.4	205	210	215	219	228	166.6	194.0	218.0
State & Local	335.0	342.2	347	354	361	370	380	309.8	338.8	366.3
Net Exports	- 2.2	21.3	10	2	- 4	- 8	-11	- 4.6	3.9	- 5.3
eal GNP (1972 dollars)	1408.6	1411.8	1414.6	1415.6	1422.0	1437.0	1452.2	1431.6	1418.7	1432.1
% change at annual rate)	- 9.6	0.9	0.8	0.3	1.8	4.3	4.3	2.3	- 1.0	1.0
mplicit Price Deflator										
% change at annual rate)	10.7	9.8	9.7	9.6	9.5	9.6	9.7	9.2	9.5	9.6
y Economic Indicators										
nemployment Rate (percent)	7.5	7.6	7.8	8.0	7.9	7.7	7.6	5.8	7.2	7.8
ousing Starts (thousands of units)	1053	1408	1375	1375	1500	1650	1750	1745	1275	1569
onsumer Price Index										
(% change at annual rate)	13.7	7.2	10.9	9.6	9.5	9.6	9.5	11.2	13.2	9.9

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U.S. BUSINESS OUTLOOK, SHORT-TERM

The 1980 economy, which from April to June registered the biggest single-quarter slump in postwar history, ended the year with a bang: Gross national product (GNP) adjusted for inflation surged by 5% in 1980's final quarter (compared to the third quarter). The last time the economy managed that kind of GNP advance was in the fourth quarter of 1978.

But despite this dramatic dollop of growth, the economy is still not strong. In fact, fourth-quarter real GNP was lower than it was a year earlier, which means that growth from October to December looked good only because it was measured against depressed levels. Moreover, the economy is expected to welcome the new Reagan Administration by stagnating in the first half of 1981.

Considering that things went rolling along pretty well in 1980's fourth quarter, why should the economy waffle? The short answer is that part of last quarter's strength was probably borrowed from the first half of 1981. More specifically, even though interest rates were high and rising, housing starts and car sales managed to show strength last quarter. And spending on cars, houses, and house-related goods like furniture--a sizable chunk of GNP--accounted for more than half the fourth-quarter GNP growth. If this kind of spending falters in the first half of 1981, as expected, economic momentum building in the final months of last year will be curbed.

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The Slow Road Ahead for Cars and Houses

Towards the end of 1980, the prime rate shot past the previous all-time high of 20% and mortgage rates climbed into the 15%-16% range. Looking back to 1980's second quarter reveals that such lofty rates of interest imply severely depressed levels of car sales and housing starts. Yet in the fourth quarter, domestic car sales topped the second-quarter figure by 18% and housing starts were up 48%.

The rise in housing starts is less difficult to explain than the rise in car sales: Last September, the U.S. government supplied funds to boost construction of multi-family residential units. As a consequence, multi-family starts took a jump and the government-induced momentum of this sector has continued. Starts of single-family houses, meanwhile, declined by some 10% from September to December. With mortgage rates remaining at very high levels, single-family starts are expected to drop further, while the energy infused into the multi-family sector via Washington is soon expected to run out. Therefore, total housing starts are forecast to fall to 1.275 million units (annual rate) in 1981's first quarter, down 18% from 1980's fourth quarter.

In contrast to the housing sector, no special factors--such as government subsidies--were at play in the auto market. How then could auto sales shift out of first gear as rising finance rates and prices seemed to block any advance?

Perhaps the driving force behind the sales increase was a 3% jump in consumers' real disposable income--the amount of money people have left over after paying taxes and certain other fees. (This gain in spendable income, in turn, arose from a healthy spate of job creation--employment in the fourth quarter jumped by nearly 800,000.)

Having put off purchase of a new car for months, and with more money in their pockets, a surprising number of people apparently opted to bite the financing bullet and buy an auto. (Some were also attracted by Chrysler's new cars and sales promotions: In percentage terms, Chrysler's fourth-quarter sales rose much more rapidly than did overall sales of U.S.-made cars.)

The total number of new cars sold in the U.S. in the fourth quarter was nearly 9.1 million (seasonally adjusted at an annual rate), compared to 8.7 million in the preceding quarter. But imports accounted for about half the increase, suggesting that the U.S. industry is hardly out of the woods and that the U.S. economy will not soon be getting a big lift from the domestic auto industry via increases in employment and orders. Moreover, the domestic industry may now be deeper in the woods due to a combination of oil price decontrol, making car buyers even more sensitive to fuel efficiency, and bottlenecks in small car production, perhaps turning buyers away to more readily available imports.

Yet even if buyers are shopping around, they may begin to delay purchase not only because finance rates are still high, but for other reasons as well. For example, as of Jan. 1 a higher Social Security tax went into effect, reducing the amount of money that wage and salary earners will have in their pockets. At the same time, consumers may want to increase their savings, which increased less in the fourth than in the third quarter. And, too, people may continue to show caution in taking on more installment debt. (The ratio of installment credit outstanding to personal income has been falling fairly quickly for the past year.)

In sum, the economy's Welcome Wagon should be greeting the new White House resident with a picture of the auto and housing industries that is not very bright. And even if deterioration is not serious--car

sales in fact spurted in January--both of these industries are already in a depressed condition. The table below, which compares cars and houses at similar stages of previous business cycles, shows that these industries are well below levels of activity achieved a decade ago. Also note

Autos, Houses, and Interest Rates During Economic Recovery

Year and Quarter	Prime Rate (%)	Domestic Auto Sales (Millions)*	Housing Starts (Millions)*
1970 IV[t]	7.23	7.7**	1.707
1971 I	5.88	8.5	1.826
1971 II	5.39	8.3	2.020
1971 III	5.97	8.7	2.094
1971 IV	5.44	9.2	2.202
1975 I[t]	8.98	6.7	0.976
1975 II	7.32	6.3	1.071
1975 III	7.56	7.6	1.250
1975 IV	7.58	7.7	1.342
1976 I	6.83	8.9	1.442
1980 II[t]	16.32	5.5	1.053
1980 III	11.61	6.5	1.412
1980 IV	16.71	6.6	1.556

*Seasonally adjusted at annual rate.

**Figure is for 1970-III since a fourth quarter strike pushed sales down to an "artificially low" 5.4 million.

[t]Trough of business cycle.

that in the two previous business cycles, interest rates declined in the initial stages of recovery, and a year after recovery began they were still well below the recession peak rates. But in the current business cycle, after dropping sharply from the trough of the cycle, rates zoomed right back up and even topped the previous peak.

As the table shows, falls in rates are accompanied by rises in both car sales and housing starts. Of course gains in real income were also working to boost activity. But because interest rates this time around shot right back into the stratosphere, spending on cars and construction of houses are expected to behave differently at this stage of the business cycle than they did in previous stages. In fact, they are expected to help keep the economy from continuing its rapid growth.

By the third quarter, however, consumer appetites should be whetted by personal tax cuts totaling $25-$30 billion. The forecast assumes that consumers initially save a big chunk of their newfound income (as they did in 1975 when taxes were cut), but that by the fourth quarter of 1981 they adjust to the income increase and spend a typical proportion of it.

Meanwhile, some moderation of mortgage rates plus a large pent-up demand for houses is expected to push housing starts up beginning in 1981's second quarter. But starts are not expected to reach robust levels until 1982.

Capital Spending: Grounded, But Set For Midyear Takeoff

After skidding by 3.4% in real terms last year, business fixed investment--fueled by tax cuts and an improving economy--should be revving up in 1981. And as 1982 dawns, capital spending should shoot into high orbit.

Already encouraged by the economy's advance in 1980's second half, firms in the fourth quarter stepped up their orders for nondefense capital goods by nearly 17% from the third quarter. More spectacularly, the F.W. Dodge value of contracts signed for construction of commercial and industrial buildings surged by 26% in the fourth quarter compared to the third. And though orders and contracts take some months to be translated into actual investment, these indicators suggest that capital spending is getting set for a rebound.

Moreover, while business purchases of autos sagged last quarter, the surge in used car prices coupled with rebates on new cars could well spur companies to trade in old fleet models for new ones.

In the meantime, as expected, capital spending adjusted for inflation slipped in each succeeding quarter of 1980. Since spending is currently so weak, the buildup of capital expenditures through 1981 will raise the annual level of spending only about 8% above 1980. Real capital spending in 1981, therefore, is expected to decline by about 1%-2%.

The projected annual figure, though, hides a spending pattern marked by a sharp increase in the second half. Given the election of Ronald Reagan and a Republican Senate, it is assumed that companies have

been revising capital budgets upward in anticipation of tax cuts favorable to investment. Since firms would reasonably want to hold back on investment until they know exactly what the tax provisions are, and since the cuts are expected at midyear, the forecast is that capital spending will react beginning in 1981's second quarter.

Inflation and Interest Rates: Little Relief Ahead

While one of Ronald Reagan's chief public enemies is inflation, one of his first acts as President will surely cause the consumer price index (CPI) to blip up. The President's decontrol of oil quickly spurred a rise in wholesale prices of gasoline, and if these increases are passed through at the pump, the CPI in February could rise by several tenths of a percent on that account alone. Since rising mortgage rates will also be putting upward pressure on the price index, the inflation forecast--as measured by the (annualized) percent change in the CPI--is a hefty 13% for the first quarter of 1981.

Since the oil price hikes are expected to be passed through fairly quickly, the rate of (CPI) inflation is seen declining in the second and third quarters in response to a soft economy. Contributing to the drop should be modest decline in mortgage rates.

However, mortgage rates--and interest rates in general--are not expected to nosedive as they did last spring after the prime hit 20%. In fact, rates are expected to remain high, for two reasons: Supply and demand.

On the supply side, the Federal Reserve Board has resolved to keep a close watch on the printing presses, limiting money supply (M1-B) growth to some 4%-6% for the year. On the demand side, the federal

government budget deficit this year will be huge ($50 to $60 billion), and if Congress cuts taxes before cutting the budget the government's requirements will be even huger. At the same time, business will be seeking increased funds to finance purchases of plant and equipment. And with a big unmet demand for houses building up for a year, the mortgage market is expected to be under pressure towards the end of 1981. Put together a moderate supply of and a strong demand for money, and the chances for a significant slide in interest rates are small. The only cause for a decline in rates this year would be a slowing down of the inflation juggernaut, which at least for the moment is being carried forward on a wave of oil price rises.

In short, high rates of interest and high rates of inflation appear firmly affixed to the 1981 economy.

The Economic Boom You May Have Missed

In case you didn't notice, the gross national product has taken a great leap forward. The government's estimate of 1980 third-quarter GNP suddenly shot up by $50 billion (annual rate) over what had been estimated earlier. Net exports in that quarter were more than doubled to $44.5 billion and nonresidential fixed investment surged by $23 billion.

No, the economy did not suddenly jump onto a super-growth track while your company was just dawdling along. What happened was that government statisticians entirely reworked the GNP accounts going back to 1968. They included information that was not available when earlier GNP estimates were made; they changed definitions of some categories; and they changed some procedures for estimating the accounts.

The most noticeable differences between the new numbers and the old are in net exports and nonresidential investment. The big kicker to the new net exports numbers is the addition of U.S. overseas affiliate earnings that are reinvested abroad. Exports are recorded in the GNP accounts as "net," so the reinvested earnings of foreign companies operating in the U.S. are subtracted out. But since U.S. investment abroad far exceeds foreign investment here, this new component of net exports "blows up" that account, tacking billions onto GNP. The revised 1979 GNP figure, for example, is $15 billion higher than previously due to the inclusion of reinvested earnings.

Nonresidential fixed investment is higher than before for two reasons. One is that spending on hotel and motel construction, formerly considered residential investment, is now being included in nonresidential investment. This change, however, only adds a couple of billion dollars to nonresidential fixed investment and does not affect GNP at all because it merely involves shifting dollars from one part of the GNP accounts to another.

The second reason for the boost in investment is that government statisticians altered the method by which they figure purchases of producers' durable equipment. (Nonresidential investment consists of two components--structures and producers' durable equipment.) They also took into account new information--namely, the 1972 input-output table of the U.S., which became available in 1979. As a result of these technical changes, the estimate for equipment spending was raised substantially. In 1979, the boost was more than $20 billion.

Thus, between the addition of reinvested earnings and the new estimates of producers' durable equipment, GNP in 1979 was raised by about $36 billion, or 80% of the total increase due to the government's revision.

The GNP revisions are significant and have important implications for analysis of the U.S. economy over the past decade. But they do not materially affect the short-term business outlook. Essentially, the only things changed in the outlook are the levels of certain GNP components--particularly net exports and nonresidential fixed investment. But the quarter-to-quarter and year-over-year percent changes in the components are not affected by the revisions. The essence of a forecast is its pointing to future change and rates of change, and the measurement of rates of change are not affected by the levels of the components in the GNP accounts.

Summary

Since its precipitious plunge in the second quarter of 1980, the economy has bounced back smartly, by 2.4% and 5% in the third and fourth quarters respectively. Nonetheless, the economy has yet to absorb the impact of high interest rates, which should work to cut house construction and restrain consumer car purchases in the first half of 1981.

In addition to feeling the pinch of near-record interest rates, consumers will also be contending with the somewhat bigger bite that Social Security taxes will be taking out of their paychecks. The expected result: Consumer spending will show little strength in real terms in the first part of this year. After income taxes are cut at midyear, however, consumer spending should pick up.

Business capital spending will also start the year without zip, but it too should feel the spur of tax cuts at midyear. With momentum building in 1981, capital spending in 1982 should soar. In the near term, meanwhile, business' purchases of autos could be relatively strong.

Despite a soft economy in 1981's first half, inflation rates and interest rates are nevertheless expected to remain high. The consumer price index will be pushed up by fuel prices and mortgage rates; interest rates in general will be prevented from falling too far because borrowers with big needs--especially the federal government--will have to bid against one another for a pool of funds that will grow only moderately.

All in all, 1981 should be a turnaround year, with the economy finally settling into a continuous growth path after wobbling around for the past two years. For the year as a whole, however, growth is forecast at only a little more than 1% because of expected sluggishness in the first half. Thus, while the good news is that the last half of 1981 will prepare the way for a strong 1982, the bad news is that slow growth at first, complicated by rising prices and uncomfortably high financing costs, will make 1981 a difficult year for business managers.

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Department of Economics

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	-----Actual-----		----------Forecast----------						-----Annual-----	
	1980		1981				1982			
National Product Accounts	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	1980	1981
Gross National Product	2637.3	2741.4	2821.5	2877.5	2968.5	3079.5	3182.5	3287.0	2628.8	2936.8
Consumer Spending	1682.2	1744.4	1799.0	1835.0	1889.0	1955.0	2011.0	2072.5	1671.1	1869.5
Gross Private Domestic Investment	377.1	403.7	422.5	435.0	461.5	492.5	524.5	552.5	396.8	452.9
Fixed Investment	393.2	409.4	419.0	429.0	451.0	477.5	506.0	533.0	399.8	444.1
Nonresidential	294.0	297.3	304.0	310.0	323.0	337.5	352.0	367.0	294.7	318.6
Residential	99.2	112.2	115.0	119.0	128.0	140.0	154.0	166.0	105.1	125.5
Inventory Change	- 16.0	- 5.7	3.5	6.^	10.5	15.0	18.5	19.5	- 3.0	8.8
Government Purchases	533.5	558.8	570.0	582.5	596.0	617.0	631.0	644.0	524.8	591.4
Federal	194.9	213.3	217.0	222.0	226.0	236.5	240.5	246.5	199.2	225.4
State & Local	338.6	345.5	353.0	360.5	370.0	380.5	390.5	397.5	335.6	366.0
Net Exports	44.5	34.5	30.0	25.0	22.0	15.0	16.0	18.0	26.1	23.0
Real GNP (1972 Dollars)	1471.9	1490.1	1495.8	1490.2	1501.9	1521.3	1535.2	1548.3	1481.8	1502.3
(% change at annual rate)	2.4	5.0	1.5	- 1.5	3.2	5.3	3.7	3.5	- 0.1	1.4
Implicit Price Deflator										
(% change at annual rate)	9.2	11.2	10.5	9.8	9.8	10.0	10.0	10.0	9.0	10.2
Key Economic Indicators										
Unemployment Rate	7.6	7.5	7.7	7.8	7.8	7.6	7.4	7.4	7.2	7.7
Housing Starts (thousands of units)	1412	1556	1275	1350	1550	1650	1740	1790"	1321	1456
Consumer Price Index										
(% change at annual rate)	7.2	12.3	13.0	11.5	9.5	10.1	10.5	10.5	13.4	11.3

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U.S. BUSINESS OUTLOOK SHORT-TERM

Driven by auto sales, business investment, and exports, real gross national product (GNP) zoomed up by 8.4% at an annual rate in 1981's first quarter--far beyond the earlier expectations of economic forecasters. But this explosion of growth does not herald the beginning of a 1981 boom. In fact, though McGraw-Hill has raised its projection for real 1981 growth, it still sees a lackluster economy in the near term. Beyond the next several months, however, the economy promises to pick up steam, and to continue sailing ahead into 1982.

The near-term pessimism in part reflects an expected turnaround in the ultra-surprising first-quarter statistics: Car sales revved up in February and March in response to manufacturers' rebates; but the rebates have ended, and subsequent sales plummeted. Net exports soared in the first quarter; but the net export numbers can shift around a lot from quarter to quarter, and predicting their movement is difficult. Real capital investment spurted by 13.4% (annual rate) in the first quarter, but recent evidence suggests this spurt may fade.

In short, while rosy first-quarter statistics show the economy to be aglow with good health, symptoms that point to further problems still persist. Thus, full recovery from the 1980 bout with recession is not expected until later in the year.

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Will the Second "Dip" Ever Come"

For a half year now, many economists have been looking for a "double-dip" recession--the first dip being 1980's second quarter (when real GNP plummeted by 9.9%) and the second dip yet to appear. McGraw-Hill thinks a second dip may be in progress right now due to a "correction" of events in the robust first quarter of the year.

One correction already well underway is in autos, where the rebate-fueled sales boom has turned to bust. As shown in Chart 1, sales

Chart 1. The Auto Boom/Bust

10-Day Period	Domestic Auto Sales (Millions of Units, Seas. Adj.)	Comments
February		
1st 10 Days	6.90	
2nd 10 Days	6.29	
3rd 10 Days	10.34	Rebates go on.
Average	7.84	
March		
1st 10 Days	8.22	
2nd 10 Days	9.59	
3rd 10 Days	5.11	Rebates go off.
Average	7.64	
April		
Average	5.76	

of domestic autos jumped into high gear at the end of February when the rebates took effect. Then, even more dramatically, car sales crashed at the end of March when the rebate programs came to a stop. Nonetheless, just this short spurt of heavy auto buying caused real consumer purchases of motor vehicles and parts to leap by 50% (annual rate) in 1981's first

quarter, while business purchases of autos skyrocketed by some 60% (annual rate). Together, these purchases tacked about two percentage points onto the first-quarter growth rate of 8.4%.

The corollary is that with the sharp reductions in car purchases--reductions that continued into May--the auto sector will help drag the economy down in the second quarter. Auto sales may get some help from the introduction of new models this spring by Ford and General Motors, but stiff sticker prices and the new round of interest rate rises may well dampen any enthusiasm the new models create.

Consumer purchases of durable goods other than autos will likely be weak, too, primarily because they are tied to the housing market; and housing activity will not be able to get far off the floor with mortgage rates over 15%. Moreover, as shown in Chart 2, consumers dipped deeper

Chart 2. The Consumer Shows Restraint

1980 Quarter	Consumer Durables Sales[1]	Savings[2] Rate	Credit as % of Personal Income
I	$145.4	4.9%	14.76%
II	126.2	6.2	14.44
III	132.6	6.1	13.86
IV	139.1	5.1	13.52
1981 Month			
January	146.0	4.7	13.37
February	146.8	4.7	13.35
March	146.4	5.0	13.38

[1]Billions of 1972 dollars, seasonally adjusted. [2]Percent of disposable personal income.

into incomes (saved less) in January and February in order to buy all those cars and other items. If people begin to save a bit more of their income as they did in March, purchases of durables will lose the strong momentum they picked up in January.

Also pointing to weakening consumption in the near term is the recent sluggish growth of personal income, the key determinant of spending. Real disposable income barely advanced in March and perhaps declined in April. If this is not enough to jar consumer confidence, consider the interest rate runup in May, which came at a time when consumers seemed to want to reduce their debt burden. (See Chart 2, where the last column shows a steady decline in the amount of outstanding installment credit as a percent of income.) With interest rates expected to remain high, it therefore appears that consumers will think twice about taking on much new debt in the near future.

In sum, all these financial constraints, plus the fact that reduced price tags are no longer being dangled by auto dealers, add up to consumer restraint in the spring quarter. And a couple of early indicators support this scenario--sales of retail stores fell by 1% in April, and personal consumption rose by just 0.2% before taking inflation into account. (Meanwhile, the consumer price increase in April increased by 0.4%.) If the consumer turnaround continues, the second quarter could be weak indeed.

Capital Spending: Caution Still Rules

Another pivotal point this spring and summer will be capital spending. As already noted, nonresidential fixed investment in the first quarter surged, suggesting that business has regained confidence in the

economy and is charging ahead with plans to build factories and offices and to buy machinery and equipment.

However, a recently conducted McGraw-Hill survey found that companies plan to increase real capital spending in the U.S. by less than 2% this year. If those plans are realized, it means that inflation-adjusted plant and equipment expenditures would have to weaken in the wake of the first quarter's 13.4% leap. And, in fact, there are good reasons for capital investment to flatten in the near term.

One is that companies, like consumers, took advantage of auto rebates in the first quarter in order to replenish their fleets. Business purchases of autos, therefore, may decline in the current quarter. Secondly, while private nonresidential construction went up sharply in the first quarter, the big increase occurred in January--since then, activity has leveled off. Moreover, the value of contracts signed for new commercial and industrial buildings fell in the first quarter, indicating that construction could weaken in the spring. On the equipment side of capital spending, a leading indicator--new orders for nondefense capital goods--dipped in April.

More generally, business still has not fully recovered from the short but sharp 1980 recession: Cash flow is improving, but it's not yet strong; industrial operating rates gave gained but are still low; and demand, while picking up, is not much above pre-recession levels. In addition, the May takeoff in interest rates could further put the kabosh on capital spending.

But spurred by sales growth and tax cuts in the latter part of 1981, business is expected to hike fixed investment by a hefty 16% in 1982.

Housing: More Bad News

While the economy is expected to slip in the spring and early summer due to unfavorable turnarounds in consumer and business capital purchases, residential investment is already depressed and will thus also contribute to economic weakness. Moreover, despite upticks in March and April housing starts it is hard to envision a robust buildup in housing activity at least until next year. Mortgage rates are just too high, and they have little prospect of declining much in 1981: Savings and loan associations now garner most of their funds from financial instruments with interest rates linked to market rates; and since these rates are well into the double-digit range, S&Ls will have to keep mortgage rates up.

Yet even though they have aggressively marketed their six-month money market certificates, S&Ls have had trouble attracting funds from the public. In March and April, for example, federally insured S&Ls suffered a huge outflow of funds, thus crimping their ability to make new mortgate loans.

Because mortgage funds will be costly and less than abundant, McGraw-Hill forecasts second-quarter housing starts to average only 1.25 million (seasonally adjusted annual rate), far below the number needed to meet demand that has been pent up for over a year. As financing gets more and more creative, and as prospective homebuyers stop wishfully thinking that mortgage rates will come back down to, say, 1979 levels (11% on average), some will likely bite the monthly payment bullet and enter the market. Thus, residential construction is expected to rise to 1.5 million starts by 1981's fourth quarter--still low, but enough of a gain to help the economy along the road to growth.

The Reagan Era: More Inflation, Higher Rates?

Essentially, then, the economy appears to be in a transitional phase: The recession is over and real GNP is now higher than it was before the recession. But recovery thus far has still left the economy in a volatile state.

For once again, sustained and stable economic growth is haunted by the specter of high and rising interest rates. While falling from 21.5% in December to 17% in April, the prime rate more recently took another turn up in its now familiar roller-coaster fashion. Housing, as usual, will get hit hard, while rebateless auto dealers also suffer. Meanwhile, the mirror image of the interest rate rise has been the stock market fall.

Ironically, the financial markets' volatility comes at a time when a pro-business President is selling a program for economic recovery and largely getting Congress to buy it, a paradox which may prove once more that the economy indeed moves in mysterious ways. But there are at least three explanations for the disturbingly sharp interest rate rise: One is that economic expansion has spurred a fairly strong demand for funds from the private sector, while at the same time the federal government has to borrow tremendous sums to cover its deficit (estimated at roughly $60 billion this year). Two, as demand for funds rose, the Federal Reserve Board vowed to maintain its tight monetary policy, and in fact it has. However, while keeping its eye on the monetary targets, the Fed's hand has wavered at times, producing jerks in money growth from week to week; and these jerks give money market participants the jitters, causing them to play safe by demanding higher returns on the funds they advance.

The third explanation for the interest rate jump is that the money markets really think the Reagan program is inflationary; so in order to protect their investments lenders are demanding higher risk premiums.

The McGraw-Hill forecast assumes interest and inflation rates will stay at high levels in the next year and a half, but that no further surge in rates is warranted. In fact, the Reagan program seems to be on the right track; and in conjunction with the Fed's stated policy of gradually slowing money growth, it should eventually lead to lower rates of inflation and interest.

To see why it appears that financial markets have been overreacting, consider Chart 3, which compares the proposed Reagan personal tax cuts with major personal tax reductions proposed under Presidents Kennedy and Ford. A major argument levied against the

Chart 3. Reagan vs. Kennedy & Ford

Year of Tax Cut	Personal Tax Cut as % of GNP	Federal Deficit as % of GNP	Amount of Economic Slack vs. 1981	Inflation Rate
1964	1.3%	0.5%	less	1.5%
1965	0.4	surplus		2.2
1975	1.0	4.5	more	9.3
1976	0.8	3.1		5.2
1981	0.6	2.0	---	---
1982	1.6	1.4	---	---

NOTES: Tax cuts are the reductions in taxes under new laws compared to what would have been paid under old laws. Estimates of these cuts in 1964-65 and 1975-76 are from various issues of the Economic Report of the President. Estimates for 1981-82 are by the Reagan Administration. Economic slack was measured by the unemployment rate and manufacturing capacity utilization rate at the time of the tax cut. Inflation was measured by the GNP implicit price deflator. McGraw-Hill's forecast of 1981 GNP, and the Reagan Administration's forecast of 1982 GNP are used in the calculations

proposed Reagan tax cut is that it would come at a time of high inflation. By contrast, the widely acclaimed 1964 tax cut was passed when inflation was very low--1.5%. The conclusion is that a Reagan tax cut would be highly inflationary.

However, when taxes were reduced in 1964 the economy had already been expanding for three years. The economy now has been expanding for only three quarters. Not surprisingly, then, the unemployment rate today is higher than it was in early 1964, and the manufacturing operating rate is lower. In other words, resources are much more underemployed in 1981 than they were in 1964. A tax cut now, therefore, seems more appropriate.

And even though the economy was relatively strong in 1964 inflation did not shoot up after taxes were cut. True, the inflation rate rose by 0.7 percentage points in 1965; but then this was the beginning of the Lyndon Johnson guns-and-butter big-spending era. Furthermore, the conclusion that tax cuts inevitably lead to higher inflation is not borne out at all by the experience of 1975-76. In fact, in the year following the 1975 tax cuts, the inflation rate fell by nearly half. At the same time, it should be noted that there was greater slack in the economy in 1975 than in 1981, so that expansionary fiscal policy had more room than now to stimulate output rather than prices.

Another worry about the Reagan tax proposal is that it will lead to burdensome federal budget deficits. Chart 3 shows that the loss of government revenue due to tax relief--relative to the whole economy--would be smaller in 1981 than in 1964 or 1975. If the

Administration's projections for next year remain valid, the impact of the tax cuts would indeed rise. However, as a share of GNP, the federal deficit is projected to decline, so that the tax cuts would not be creating undue pressure on financial markets or on the Federal Reserve Board. In 1975-76, the federal deficit was relatively much larger, yet the inflation rate declined. (The size of the upcoming tax cuts and the resulting deficit may, of course, be smaller than currently projected, since Congress seems to be tilting to smaller cuts.)

Perhaps a more important point, though, is that both the 1964 and 1975 tax cuts were followed by a half decade of rapid growth. Thus if the Reagan cuts go through, the McGraw-Hill forecast anticipates that growth later this year and next year will likewise be spurred.

The response to the cut this may be muted, however. As for the business tax cuts, firms responding to a McGraw-Hill survey last winter said the Administration's "10-5-3" accelerated depreciation plan (if adopted in mid-1981) would only boost capital spending by a half a percent this year, and the impetus to investment would come in 1982.

As for the consumer tax cut, it is likely that people will at first save a big chunk of their newfound cash. In both 1964 and 1975, for example, the savings rate rose when the tax cuts became effective. (In 1964, moreover, the savings rate stayed at a higher level; in 1975, after bouncing way up initially, the rate trailed down.) Thus, the refunded tax money is expected to feed into consumption in a gradual way, so that it will not blow inflation sky-high as critics of the tax plan charge. The tax cut will, nonetheless, play a role in stimulating consumer spending late this year. More important as a stimulus to consumption in

the near term, however, will be the Social Security benefit increase of 11+%, slated to go into effect on July 1. All told, consumer spending is forecast to rise by 12% (annual rate, including inflation) in the second half of 1981, thus helping to pull the economy onto a 3%-4% real growth path by yearend.

Thus, the Reagan tax cuts are expected to have a salutary effect on the health of the economy. They are expected to stimulate growth in consumption and capital spending late this year and next year; and, relative to the size and state of the economy, they are not viewed as outsized and therefore inflationary. There is, of course, an inflationary danger: The Fed may reverse field and start churning out dollars to meet the government deficit. But this possibility appears slim.

Nonetheless, financial market participants are worried, and that worry translates into a headache for consumers and businesses by way of rising interest rates. McGraw-Hill expects interest rates to stay high for reasons of money demand and supply. But it does not believe that current money market fears are justified; and once it's apparent that inflation is not about to ratchet up, rates will stabilize- albeit at high levels--in the next year. In other words, while the recent bad news on interest rates is understandable, it is not taken as an evil omen that the new floor under the prime rate will be, say, 25%.

Summary

After growing for three quarters in a row (topped off by the stunning 8.4% growth of 1981's first quarter), the economy seems clearly

out of recession. At the same time, autos and housing remain very weak. And these two industries, coupled with a possible slowdown in business investment and net exports, are expected to reverse the economy's first-quarter momentum. In fact, McGraw-Hill projects a small drop in 1981's second quarter.

But rather than signaling a period of renewed recession, the economic slowdown this spring should merely be a short interlude preceding renewed expansion. Thus, the forecast calls for real growth this year of 2.6%, followed by better than 3% growth in 1982.

A key cause of renewed growth will be the Reagan tax cut (scaled down by Congress), which is expected to stimulate both consumer and business spending later this year. Yet while promoting expansion, the tax cut is not considered large enough to kick off another inflationary spiral. And once markets perceive that inflation is not headed ever upward, the inflation premium that lenders tack onto interest rates will be reduced and rates will ease. With rates easing, the housing and auto industries should revive somewhat, and companies will be more favorably disposed to capital projects and inventory building.

To say that the increase in inflation and interest rates will abate is not, however, the same thing as saying they will fall very much. On the contrary, while the forecast assumes rates will trend downward during the remainder of 1981, the level of rates through 1982 is expected to remain high. This is why housing starts are not expected to take off as they should, given the underlying demand for housing; and it is why economic growth in general is not expected to reach the Reagan Administration's target of better than 4%.

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual		Forecast					Annual		
	1980	1981	1981			1982				
	4Q	1Q	2Q	3Q	4Q	1Q	2Q	1980	1981	1982
National Product Accounts										
Gross National Product	2730.6	2853.8	2908	2989	3079	3186	3285	2626.1	2957.5	1336
Consumer Spending	1751.0	1805.8	1842	1894	1950	2013	2070	1672.8	1873.0	2101
Gross Private Domestic Investment	397.7	435.4	44[illegible]	462	482	512	539	395.3	455.9	553
Fixed Investment	415.1	432.8	435	450	467	492	514	401.2	446.2	528
Nonresidential	302.1	316.1	323	335	345	360	375	295.9	329.8	383
Residential	113.0	116.7	112	115	122	132	139	105.3	116.4	145
Inventory Change	-17.4	2.6	9	12	15	20	25	-5.9	9.7	25
Government Purchases	558.6	575.5	587	598	616	631	646	534.7	594.1	653
Federal	212.0	221.5	225	229	239	244	251	198.9	228.6	254
State & Local	346.4	354.1	362	369	377	387	395	335.8	365.5	399
Net Exports	23.3	37.0	35	35	31	30	30	23.3	34.5	30
Real GNP (1972 Dollars)	1485.6	1516.0	1511.6	1519.6	1529.5	1547	1559.8	1480.3	1519.3	1566.5
(% change at annual rate)	3.8	8.4	-1.2	2.1	2.6	4.7	3.4	-0.2	2.6	3.1
Implicit Price Deflator										
(% change at annual rate)	10.7	10.0	9.0	9.3	9.8	9.5	9.4	9.8	9.7	9.4
Key Economic Indicators										
Unemployment Rate	7.5	7.3	7.4	7.5	7.5	7.4	7.3	7.1	7.4	7.2
Housing Starts (thousands of units)	1535	1388	1250	1300	1475	1550	1640	1304	1353	1655
Consumer Price Index										
(% change at annual rate)	12.9	10.8	7.5	8.7	9.1	9.2	9.4	12.6	9.9	9.1

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August, 1981

U.S. BUSINESS OUTLOOK, SHORT-TERM

After sprinting ahead at a super-fast pace in 1981's first quarter, the economy reversed field in the April-June quarter, with inflation-adjusted gross national product (GNP) falling back by 1.9% (annual rate).

The fact that real GNP lost ground after gaining for just three quarters in a row is atypical: Once GNP starts recovering from recession (in this case, the recession in 1980's second quarter) it usually keeps advancing for several years. Yet this recent drop in GNP was not surprising at all because interest rates had climbed just too high--far, far higher than in the early stages of other post-World War II economic recoveries.

The high-rate results: Housing continued to cave in. Auto sales, following a speedup due to rebates, shifted into the slow lane. Capital spending softened. And a strong dollar (due to interest rates in the U.S. being higher than abroad) sharply reduced the competitiveness of U.S. exports.

All of the economic ills of the second quarter cannot, of course, be attributed to high interest rates. But they did play a leading role. What's worse, lofty rates are still at center stage. So what kind of economic performance is possible in the last half of this year? And with financial markets all ajitter about the inflationary

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effects of the Reagan economic program, won't interest rates remain atop Mt. Everest and thus dominante the economy into 1982?

In short, aren't we in for a serious recession?

McGraw-Hill's answer is "no," although things are seen getting worse before they get better. And, at least in a technical sense, the middle of 1981 may yet enter the record books as an official recession.

Gloom...

Today's steep interest rates will undoubtedly continue to take their toll on key sectors of the economy---housing most of all, but also autos, capital spending, and inventories.

Mortgage rates have reached record 17+% levels, and that means few houses will be sold even after all the creative financing stops have been pulled out. Thus builders will get stuck with heavy inventories and will have little incentive to put up more units. Third-quarter housing starts, therefore, are forecast to slump to the depression level of 1 million (annual rate). Since construction takes place during several quarters, the slowdown that has already occurred in housing plus a further slowdown will be a drag on future GNP.

The interest-rate crunch will, naturally, also continue to affect auto sales. But while the auto sector like housing is depressed, autos unlike housing are not expected to remain in reverse gear. One reason is that auto makers are again offering rebates. And retailers--looking over their large, high-priced inventories--may be in the mood to make attractive deals.

Nonresidential fixed investment--i.e., business' purchases of new plant and equipment--can also be bushwhacked by ultra-high interest

rates. In fact, business investment fell 6% (annual rate) in the second quarter, after the effects of inflation are stripped away. But while interest rates undoubtedly help determine business investment decisions, their impact is not always readily apparent. For example, consult the chart below.

The Influence of Interest Rates

Year and Quarter	"Real" Interest Rate (%)	Housing Investment (Billions of 1972 $)	Auto Sales (Billions of 1972 $)	Business Fixed Investment (Billions of 1972 $)
1980 I	7.1%	$ 54.2	$48.3	$165.0
II	6.5	43.1	33.5	156.1
III	2.4	44.7	36.8	155.5
IV	6.0	50.6	40.9	157.0
1981 I	9.4	51.0	48.5*	162.0
II	12.9	48.2	38.0	159.5

NOTE: The "real" interest rate is defined here as the prime rate (average for the quarter) minus the inflation rate as measured by the annualized percent change in the GNP implicit price deflator.

*Rebates in effect.

Even though real interest rates gyrated in 1980, business investment stayed roughly flat after the first quarter. Investment then shot up in 1981's first quarter in the face of rising rates. As for autos, they responded positively to the interest rate plummet in last year's third quarter, but then continued to drive ahead for two more quarters despite high and rising rates. (The rebates, of course, helped tremendously in this year's first quarter.)

The impact of interest rates on housing is more clearly traceable. In the first half of 1980, high real interest rates clobbered housing starts, thus lowering residential investment in the middle of the year. The sharp drop in rates in 1980's third quarter then led to a significant jump in housing starts which, with a short lag, led to higher housing investment at the end of 1980 and beginning of 1981. But another rapid runup in rates undermined the industry's foundations; housing investment thus fell in real terms in 1981's second quarter and will continue to fall for at least one more quarter.

But put aside quarter-to-quarter changes for the moment and consider the past year and a half as a whole. From this perspective the chart suggests that high interest rates prevented any of these key swing sectors--which together account for more than 15% of GNP--from gaining strength. In fact, despite three quarters of growth in real GNP, neither housing nor business investment was able to get back to pre-recession levels of spending; and cars just barely made it back up the hill, but only because they were given a big push by rebates.

The upshot: While there is no fixed one-to-one relationship between interest rates and economic activity, rates ultimately do matter, as they mattered in the second quarter of both 1980 and 1981. They also matter on the way down: Rates plummeted in the wake of the 1980 recession and the economy began to recover, spurred by growth in the interest rate-sensitive sectors. Yet this time around, rates remain in the stratosphere and show no signs of returning quickly to earth. It might seem, therefore, that the economy faces the specter of another serious recession.

...But No Doom

Several things, however, are expected to work in favor of the near-term economy. For starters, Social Security recipients got an 11% boost in benefits on July 1, to the tune of about $15 billion. A good piece of this increase will show up in consumer spending in the third quarter.

Secondly, uncertainty surrounding the business investment tax cuts has been removed with Congressional passage of simplified accelerated depreciation laws retroactive to last January 1. Now that firms can calculate exactly what their cash flow will be when they buy new plant and equipment, they may be less reluctant to proceed with investment plans.[1]

Consumers, of course, also will benefit from the recently approved tax cut plan. Within the time horizon of the forecast, marginal tax rates will be cut by 5% on October 1 and then by another 10% next July 1, for a total estimated tax saving to consumers of $28 billion. A 5% rate cut will hardly strike most wage earners as a financial bonanza. But with at least a little extra money in hand, with the prospects of having more next year, and with the family car or

---

[1]For technical reasons, business capital investment is also expected to show some real growth in the third quarter: Second-quarter real investment was depressed in part due to a shift in the composition of investment. Construction of oil-related structures grew significantly as a share of investment and purchases of office equipment fell. The former has a very high price deflator, the latter a low deflator. Thus the changes in relative importances in the second quarter produced a large deflator for the whole nonresidential fixed investment category--hence lower real growth. It does not seem likely that this same shift will occur again in the third quarter.

washing machine beyond the repair stage, consumers are expected to loosen up by year-end, thereby helping to stave off a major recession.

Perhaps most crucial to the assumption that no serious recession will develop is the expectation that interest rates will ease in the next couple of quarters. The key reason: Credit demands should subside.

For more than a year now, consumers have been reducing the amount of installment debt they've taken on relative to their incomes, and as incomes grow slowly in the near future so too should the growth in consumer demand for credit. On the business side, improved cash flow due to the tax cuts will ease corporate borrowing needs. Companies will also run down their inventories in the near term, since stocks rose by $20 billion in the second quarter while anticipated sales increases failed to materialize. And while a turnarund in inventories will cut GNP growth in the third quarter, it will also untie some corporate cash and thus serve to reduce the pressure on interest rates.

Moreover, in the face of persistent single-digit inflation, lenders should be willing to slice the inflation premium they tack onto "real" interest rates to insure future purchasing power.

Then again, the U.S. Treasury will be gobbling up a huge amount of funds to cover the government's deficit (estimated at $55 billion this fiscal year and $43 billion next). And the Federal Reserve is hardly likely to start priming the money pump.

Consequently, the projected dip in rates is not expected to be mighty enough to save the economy from another quarter of GNP decline. Housing will be much too weak and inventories will do too much of a flip-flop for the economy to advance in the near term.

But weakness in the third and even in the fourth quarter of this year is not viewed as prologue to tragedy. Interest rates are near their peak. And though in for some more trouble, housing, consumer durables, and capital spending are due for a rebound later this year and next. A full-blown recession, that is, seems unlikely.

Thus, after a further decline of about half a percent in 1981's third quarter, the economy is expected to pick up, with growth for 1981 as a whole registering a positive 2.2%.

If the economy does take a dip in the third quarter and then rebound in the fourth, the middle of 1981 may or may not be labeled "recession" by the official designator, the National Bureau of Economic Research. But semantics aside, the important point is that the fall in real GNP is expected to be shallow and short-lived; after some near-term weakness, that is, healthy economic growth is expected to resume in 1982.

The 1982 Boomlet

By the fourth quarter of 1981, real GNP should about be back to where it was in the year's first quarter, which is not terribly exciting news. But as the economy enters 1982, all systems should be go: Residential investment will build up quickly as housing starts rise from depression levels; capital spending will mount in response to an improved sales outlook, stonger cash flow, and the dip in interest rates; consumers, especially after next July's installment of tax cut fever, will be in a spending mood; and business will again add to inventories to keep them growing along with sales.

Exports, too, should pick up next year as the economies of major trading partners recover and as the trickling down of U.S. interest rates softens the dollar against other currencies. At the same time, though, a reviving U.S. economy will mean an increase in imports, so that the balance between imports and exports (net exports) is expected to diminish in 1982.

All in all, real growth next year is put at 2.8%, a seemingly small improvement over 1981's projected growth of 2.2%. This comparison, however, partly masks the expected vigor of next year's economic rebound. To get a better idea of the 1982 growth forecast, consider that from the fourth quarter of 1981 to the fourth quarter of 1982 real GNP is expected to spurt by a hefty 3.9%. By contrast, 1981 growth is put at only 2.1% according to this measure.

Yet even if the economy attains good growth next year, it will still be at a disappointing level. Assuming the McGraw-Hill forecast is right, the economy will have grown by only 1.5% a year on average from 1979 to 1982--by less, that is, than half its post-war average. In particular, 1982 housing starts--while way up over 1981--would still be below the 1979 level, and well below the level required to meet the large pent-up demand from people born during the baby boom.

Inflation: End of an Era?

The stunning news out of the second quarter was the drop in the broad measure of inflation--the GNP deflator--to 6%. That's down from 9.8% in the first quarter and from 9.0% in 1980 as whole.

An announcement of 6% inflation is to be welcomed with loud cheers. But alas, it is probably only a passing event. Wage hikes are still running at better than 9% a year; gasoline prices can't come down forever; likewise, good luck on the food front cannot last indefinitely. Thus, the forecast assumes a bounceback in inflation to more than 8% in the second half of 1981 and in 1982. A similar pattern is expected for the consumer price index (CPI).

But saying that the inflation rate will rise from 6% is not the same as saying that 10+% inflation is just around the corner. On the contrary, with the Federal Reserve Board not flinching in its efforts to squeeze down money supply growth, inflation will stay below double-digit levels. Very simply, if there is not enough money in the economy to finance everybody's price increases some price hikes will have to be rolled back.

The danger, of course, is that companies witnessing a fall in demand at higher price levels will take this as a signal to cut back operations and lay off employees. Ensuing economic weakness will sure enough put downward pressure on the inflation rate, the desired result; but then this route to price stability also produces undesired side effects.

No matter what route is taken, the economy seems to be in for a long spell of single-digit inflation. The personal tax cuts, big enough to let consumers feel more flush, are simply too small to result in a burst of inflation from the demand side. And the business cuts will presumably show up in more plant and equipment, which will work to raise productivity and thus lower unit labor costs.

Yes, inflationary expectations will be aggravated by big government dificits. But no, the deficits will not inexorably lead to higher rates of inflation--if they are financed via borrowing rather than by money creation. Large deficits mean the government must choose between heavy Treasury borrowings (higher interest rates) and more money creation (higher inflation). Forced to choose between two evils, the Reaganites rightly want to go for a reducton of inflation even if the Treasury does become a hog in the credit markets. For the longer the country remains in the era of single-digit inflation, the more surely will the inflation premium on interest rates fall. Thus, the Reagan Administration figures it can win on both the inflation and the interest rate fronts, even though initially it must bear the discomfort of causing rates to remain high.

This strategy is not, of course, void of considerable risks. A clash of the titans--the Treasury and the Fed--could cause another spurt in interest rates, leading to further declines in economic activity, higher unemployment, and declining incomes.

Now that it is finally in place, that is, Reaganomics would immediately be greeted by a classic recession, thus undermining the supply siders' impressive political momentum and producing charges that the U.S. is on he road to Thatcherism. Economic policy in 1982, therefore, is subject to change.

At present, however, the Administration is firmly committed to easier fiscal policy and tight monetary policy. The McGraw-Hill forecast perceives more pluses than minuses in this combination. But the risks to the forecast are definitely on the down side.

Summary

Tighter monetary policy and soaring interest rates combined to bring the economy down in the second quarter, and this duo threatens more of the same in coming quarters. Housing, for certain, will continue to crumble under the weight of 17% mortgage rates. High financing costs will also spur business to cut down inventories and to look closely at capital expenditures.

But the outlook is not entirely dark; in fact, while the forecast does call for another quarter of economic decline, a healthy rebound is projected for 1982.

Central to this forecast is the expectation that a dip in interest rates will help steady a foundering economy. The economy should also veer away from a steep recessionary course thanks to tax cut-induced jumps in consumer and capital spending. In particular, a chunk of the extra cash going into taxpayers' pockets is expected to come out again in the form of downpayment on durable goods.

Underlying the expectation that interest rates will ease are two factors: 1) Credit demands of consumers and business should subside due to recent weakness in the economy. 2) With a decline in the inflation rate, financial markets should demand less of an inflation premium on interest rates.

Since big federal deficits mean big Treasury borrowing, however, lenders will only slowly accept the idea that interest rates should decline. Thus, the drop in interest rates will probably not be as dramatic as the Reagan Administration alarum would have it. For example, McGraw-Hill forecasts that three-month Treasury bill rates

will average a bit more than 12% next year, nearly a percentage point and a half higher than the Administration projections.

But despite the continued high level of interest rates, a rate decline should encourage a pickup in economic activity. True, real GNP is forecast to fall in the third quarter. But the fall in part will be due to a swing in inventory investment; by contrast, real final sales (GNP minus inventory change) are expected to rise.

And though faltering in the near term, the economy is expected to steady itself thereafter, with all major sectors--particularly ones most sensitive to interest rates--contributing to expansion in 1982.

McGraw-Hill Publications Company
Department of Economics

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

National Product Accounts	Actual 1981 2Q	Forecast 1981 3Q	1981 4Q	1982 1Q	1982 2Q	1982 3Q	1982 4Q	Annual 1980	Annual 1981	Annual 1982
Gross National Product	2881.1	2933	3012	3108	3196	3289	3394	2626.1	2919.8	3246.8
Consumer Spending	1830.3	1870	1920	1965	2010	2069	2125	1672.8	1857.6	2042.3
Gross Private Domestic Investment	453.8	445	460	494	524	549	577	395.3	450.0	535.7
Fixed Investment	433.4	435	450	479	506	531	554	401.2	437.8	517.5
Nonresidential	322.0	330	342	355	370	385	400	296.0	327.5	377.5
Residential	111.4	105	108	124	136	146	154	105.2	110.3	139.8
Inventory Change	20.4	10	10	15	18	18	23	-5.9	11.2	18.4
Government Purchases	577.6	593	610	624	637	651	672	534.7	589.3	646.0
Federal	219.5	226	235	240	246	252	265	198.9	225.5	250.7
State & Local	358.1	367	375	384	391	399	407	335.8	363.8	395.3
Net Exports	19.4	25	22	25	25	20	20	23.3	23.9	22.5
Real GNP (1972 Dollars)	1509.1	1507.1	1516.4	1534.2	1546.6	1559.6	1575.8	1480.7	1512.3	1554.4
(% change at annual rate)	-1.9	-0.5	2.5	4.8	3.3	3.4	4.2	-0.2	2.2	2.8
Implicit Price Deflator (% change at annual rate)	6.0	8.0	8.5	8.2	8.2	8.5	8.8	9.0	8.8	8.2
Key Economic Indicators										
Unemployment Rate (%)	7.4	7.6	7.7	7.5	7.3	7.0	6.9	7.1	7.5	7.2
Housing Starts (thousands of units)	1174	1000	1250	1450	1600	1670	1735	1304	1204	1614
Consumer Price Index (% change at annual rate)	7.5	8.2	8.0	7.8	8.3	8.4	8.4	13.5	9.8	8.1
90-Day Treasury Bill Rate (%)	14.91	14.0	12.1	11.8	11.7	12.5	12.5	11.4	13.9	12.1
AA Bond Rate (%)	14.12	13.7	12.9	12.6	12.5	12.6	12.7	12.0	13.5	12.6
Consumer Durables Spending (billions of dollars)	226.7	233	246	258	267	275	284	211.9	236	271